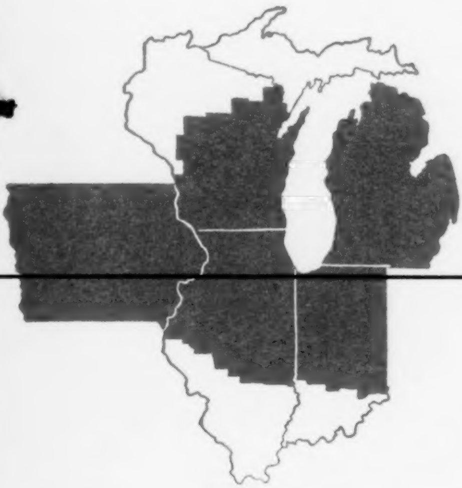
A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1956 March



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THE Trend OF BUSINESS

In recent weeks over-all business activity has leveled off at the high rates reached late last year. Industrial production was stable in January, contrasting with the steady rise over the previous year and a half. Total wage and salary employment, allowing for seasonal changes, remained unchanged from mid-December to mid-January. Jobs in manufacturing, moreover, fell moderately in the month, and average weekly hours dropped more than seasonally. Total business sales failed to increase in December, after seasonal adjustment, and it is unlikely that any further rise occurred in the early weeks of this year.

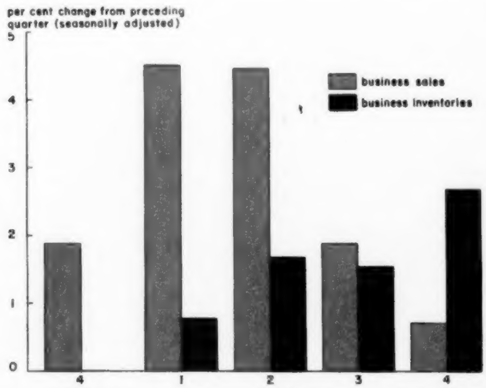
While the rise in business has halted, however, no appreciable decline is in sight. There are, in fact, impressive sources of strength to support the general level of business. Outlays for new plant and equipment have increased substantially in recent months and are expected to rise further through at least midyear. Manufacturers' new orders were at peak rates at year-end, and order backlogs show a sizable boost as compared with year-ago volumes. During the last half of the year the increase in personal income amounted to more than 4 per cent, a good omen for retail sales prospects.

Meanwhile, present and prospective areas of weakness have shown little evidence of widening. As expected, auto output has dropped substantially, but sales have held close to year-ago levels so far. Residential construction expenditures continue to edge downward, although there was some improvement in new contract awards in January and housing starts were maintained after allowance for seasonal changes. Farm prices and income are well below earlier levels, but little further weakening is expected in the months ahead.

Probably the greatest uncertainty at present concerns the future course of business inventories. Additions to stocks in recent months have provided significant stimulus to the current output of goods. More than half of the gain in GNP between the third and fourth quarters last year was accounted for by a boost in inventory buying. The question is whether the present build-up will lead to a substantial slowing or even a reversal in inventory trends later in the year.

Business inventories have risen more sharply in recent months than during the summer or fall. Monthly increases averaged 700 million dollars from September through December, after seasonal adjustment, as compared with 400 million dollars in the third quarter. A large part of the increase at retail was accounted for by the sharp expansion in automo-

Business sales increase slackens while inventories climb more rapidly



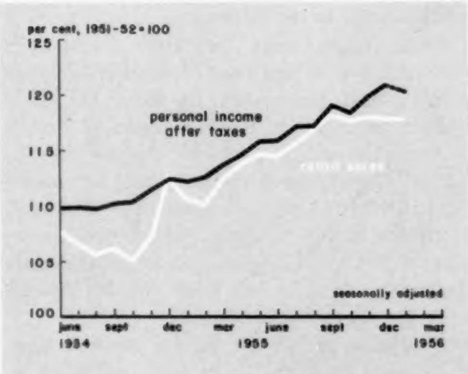
bile dealers' inventories, but manufacturers' stocks—particularly in the durable goods lines—also have increased more rapidly than in earlier months. To some extent, the recent growth has represented higher prices as well as increased volume, since wholesale prices of industrial materials and products have risen 3½ per cent since June.

By year-end, total business inventories had advanced 7 per cent, or 5.2 billion dollars, from the October 1954 low. Although this is a sizable increase, the growth in inventories generally has been modest as compared with the expansion in sales volume. Manufacturers' sales are up one-fifth from the 1954 low, while retail volume has increased 12 per cent. Since midyear, however, stocks have tended to rise more rapidly than either sales or new orders and, more recently, sales have leveled out. Thus, even though inventories in the aggregate are not dangerously high, businesses may not desire to accumulate goods at the recent rate for much longer unless the advance in sales is resumed.

Automobile output cuts, to a considerable extent, reflect the building of inventories in this sector to a clearly burdensome level. By the end of January, dealers' stocks had soared to about 830,000 units—nearly double the level three months earlier. This compares with 480,000 a year earlier and the previous peak of slightly more than 700,000 reached in May and July of 1955. As a consequence of the rapid build-up in stocks, output was cut 18 per cent from November to January, and February schedules called for a moderate further reduction to about 600,000 assemblies.

Sales of the 1956 models so far have been close to the year-ago volume, with December the same and January only moderately lower than the year before. The real test of the market still lies ahead, however, as sales usually increase sharply in the early spring. Should the sales boost in coming months approach that of last year, excessive inventories would soon be brought into line and production could again expand. If spring sales prove disappointing, on the other hand, inventories may continue

Retail sales and income moved up together until recently



to be burdensome for some months to come.

Soft goods sales have been well maintained in recent weeks, if department store volume is any guide. Big store sales nationally were up 5 per cent from last year in the four weeks ended February 11. Volume in District stores showed a gain of 7 per cent, with Milwaukee up 9 per cent, Chicago 7 per cent and Detroit 6 per cent in the same period. Although appliance sales have run well above early 1955, the homefurnishings lines in general have contributed little to the over-all gains. Thus, the increases reflect a generally better volume in soft goods lines.

Employment trends have been considerably less vigorous in recent months than during most of 1955. Total wage and salary employment, after seasonal adjustment, increased by less than 90,000 monthly in the fourth quarter—half the average gain in the preceding six months—and showed no increase at all in January. Manufacturing employment declined slightly in December and January, while average hours dropped twice as much between the two months as in the preceding year when manufacturing activity was expanding sharply. Nevertheless, total employment was at a new high in January—2.7 million above a year ago—and unemployment was below 3 million, a

relatively low level for this time of year. Moreover, employer hiring plans, as reported to the Bureau of Employment Security, point to further gains into early spring in most major labor market areas in the nation.

Meat marketings increased substantially last year, but at the cost of drastically lower prices. Beef production exceeded the 1954 volume by 5 per cent while pork production was up 13 per cent. Reflecting the sharply higher output, meat consumption per capita increased to 161 pounds as against 153 pounds in 1954 and 136 in 1951. By year-end, however, hogs were selling at the lowest price since pre-World War II and prices of beef steers were the lowest since 1946.

This price decline has hit the Midwest especially hard since the Corn Belt specializes in cattle feeding and hog production. Prior to last year, net farm income in the Midwest had held up relatively well in the face of the national downtrend under way since 1951. But in 1955 net farm income in the heart of the Corn Belt appears to have dropped about one-fourth from the 1954 level—far more than in the nation as a whole.

The Department of Agriculture forecasts that meat output in the first half of 1956 will be larger than a year ago, but in the second half production may lag somewhat. Even so, meat supplies this year are expected to be large enough to call for per capita consumption very close to the 1955 record volume. Thus, no substantial change in the Corn Belt farm income position—either for better or worse—is indicated for 1956.

Business loan demands persist

Business loans at leading city banks, after adjustment for seasonal influences, registered their fifteenth consecutive monthly gain this January. While outstandings dropped 430 million in the first four weeks of 1956, this decline was less than the "normal" first-of-the-year reduction.

But the pace of the loan expansion so far this year is considerably below that of late 1955. The seasonally adjusted rise in January was only one-sixth the monthly average for the final quarter of last year and only one-half the January 1955 bulge.

Finance company financing

The biggest single change in the business loan picture has stemmed from 1955's largest net borrower. Sales finance companies, the group responsible for almost one-third of the 4.2 billion dollar gain in outstanding loans last year (see chart), have accounted for 75 per cent of the net decline in January. This was the largest monthly reduction in finance company indebtedness since January 1952.

Three major factors lay behind the drop, and these may continue to shape the borrowing trends of the industry as the year progresses. First, repayments on consumer instalment credit have been climbing fairly steadily and promise to continue to increase in early 1956. This will probably be accompanied by at least the normal seasonal slackening in new extensions.

Second, a temporary dip during December in funds available from the sale of commercial paper, as many corporate investors were faced with tax and dividend payment dates, boosted bank borrowing. Payoffs were subsequently accentuated after the first of the year, as corporations again started to build up their investments in these finance company notes.

Finally, the major finance companies floated over 400 million in long-term debentures dur-

ing January, a portion of which was undoubtedly used to reduce bank debt. In part, the timing of such refinancing was a reflection of the desire to "clean up" bank indebtedness at least once during the year. Underlying pressure to tap the long-term credit market, however, came from the reduced margin between short- and long-term interest costs and the fact that many lines of bank credit were fully extended.

While 1956 thus far has brought large net repayments flowing from the finance companies, leading banks have found other business customers absorbing more than their usual amounts of credit. The decline in loans to major "seasonal" borrowers—food, liquor and tobacco processors, commodity dealers and trade concerns—was less severe this January than usually is the case in the early part of the year. Although these firms typically pay down their bank lines concurrently with the seasonal paring of their inventories, the reduction in loans outstanding thus far in 1956 has been about one-third less than the runoff in the first month of 1955.

At the same time, such important non-seasonal borrowers as metals producers, oil companies and public utilities have been continuing to boost their bank indebtedness. These lines had been very substantial net borrowers in 1955, but their borrowing pace had slackened markedly at one time or another during the third and fourth quarters of the year. In January, however, net new loans to these industries were challenging or exceeding the peak quarterly rates recorded in 1955's more rapidly expanding business environment.

Midwest trends

Movements in business loans of leading Seventh District banks frequently do not match those for their counterparts over the country as a whole. For example, as the table indicates, the pro-

Total 1955 loan surge due in large part to finance company borrowing

portion of the 1955 U.S. increase in business loans accommodated at Midwest banks was substantially greater after midyear than before.

	Increase at Midwest banks as per cent of U.S. rise
1955—1st quarter	9
2nd quarter	11
3rd quarter	21
4th quarter	16

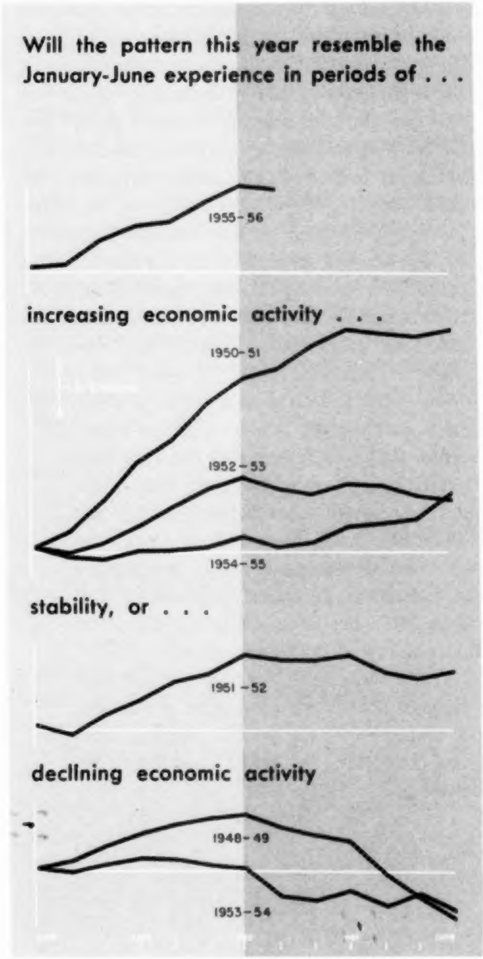
Even more striking was the January experience, when a little over one-fourth of the U.S. decline in loans was registered at District banks. In the same month last year, Midwest banks had absorbed only 2 per cent of the drop.

These contrasting loan movements result from the different credit requirements of diverse local and regional industries and, as well, from the practices of national firms in varying their borrowings among the country's leading banks. Not surprising is the fact that metal and metal product firms, including transportation equipment manufacturers, are the largest single group of borrowers at major Seventh District banks. Production of steel, machinery, autos and other consumer durables is by far the dominant industry segment in the Midwest. At the end of 1955, borrowing by such concerns represented 20 per cent of the 2.9 billion in business loans outstanding at major Seventh District banks.

During 1955 loans to the metals group as a whole rose by 40 per cent, somewhat above the one-third gain in the District total. Loans to those metals firms specializing in transportation equipment rose by fully one-half, the major portion of the boost occurring in November and December.

Sales finance companies came to large District banks often enough during 1955 to challenge the metals manufacturers for first place in the note ledgers. Finance company borrowing at the major District banks rose by over 200 million dollars last year, a resounding 75 per cent gain. The year ended with finance companies in debt to large Midwest banks to the tune of 520 million dollars, only 50 million under the metals total. This margin has widened again since the turn of the year, however, as metals firms have sought additional accommodation while sales finance concerns were engaged in heavy payoffs of their bank indebtedness. The divergence was heightened by the fact that the finance companies centered a disproportionate share of their nationwide loan repayments in Seventh District banks.

Business loans in spring



Payrolls spark income rise

In 1955, personal income from all sources topped 303 billion dollars—a gain of more than 5 per cent over the previous year. With the exception of farm proprietors, all major income sectors participated in the rise, but over four-fifths of the rise was traceable to higher wages and salaries paid to employees.

Wage and salary growth was compounded of three factors—higher employment, increased rates of pay and longer work weeks. Nonfarm employment averaged 1.1 million higher in 1955 than in 1954. Assuming no change in average earnings, this rise would have resulted in a 2.3 per cent boost in pay. But total wage and salary income rose by 6.2 per cent between the two years. Increased rates of pay and longer hours, therefore, made a substantially greater contribution to higher income than did the rise in the number of workers.

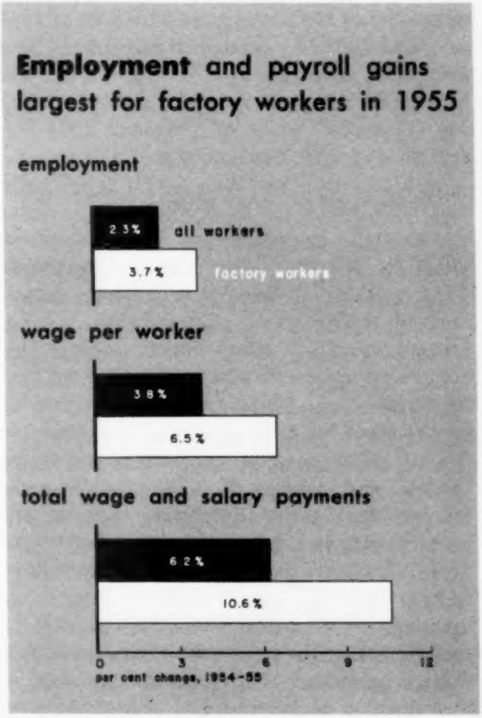
Factory pay leads upswing

Wages of manufacturing workers comprise a very important segment of employee income. Not only does this group account for one-third of nonfarm wage and salary employment, but it also undergoes the greatest swings as overall business activity rises or falls.

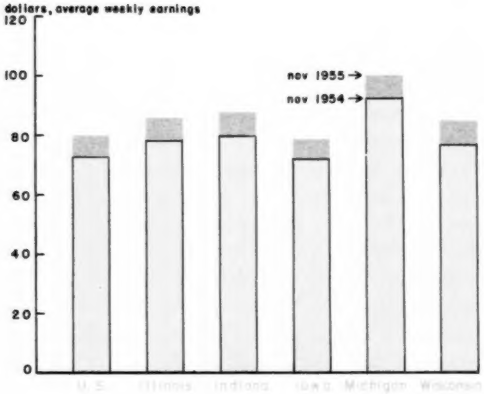
Within manufacturing, wage payments of hourly production workers fluctuate most. Production workers are hired more rapidly than others when employment is rising, and they are most affected by lengthened work weeks and "overtime pay."

Between 1954 and 1955, earnings of production workers accounted for 40 per cent of the total rise in wage and salary payments although they comprised only 25 per cent of the total number of employees. Of the 5 billion dollar increase in production worker income between 1954 and 1955, 1.9 billion was attributable to a half million rise in the number of workers and 1.3 billion dollars could be traced to an hour increase in the average work week. About 1.8 billion of the increase, therefore, can be attributed to higher earnings per hour. Of this amount approximately one-third resulted from increased payment of overtime.

Many important wage contracts are coming up for negotiation in the months ahead, although in some industries—including autos—last year's contracts provide for this year's wage adjustments and no additional negotiations are necessary. It is generally believed that new contracts will result in increases approaching those of last year. Final bargaining, of course, will be influenced heavily by the demand outlook for the products of industry at the time agreements are reached.



Manufacturing wages in Midwest outpace national gains



Average hourly earnings for all manufacturing workers have risen every year since 1933. Earnings, exclusive of overtime, averaged $1.85 at the end of 1955, compared with $.96 in 1945 and $.63 in 1939. Straight time earnings have increased as much as 15 cents in a year (1947) in the postwar period. Even during the "recession" years of 1949 and 1954, increases of 5 cents per hour were recorded.

White collar and blue

Although manufacturing wage increases aided by overtime were most important in 1955, workers in virtually all industry groups enjoyed sizable gains. Construction, mining, transportation and utility workers achieved increases approximating those obtained by factory employees. Retail and service employees, on the other hand, received lesser increases.

Little information is available on executive incomes and earnings of other salaried workers, but these groups apparently have participated in the rise. More and more, "across the board" increases for salaried employees have been granted by business firms to retain existing staff and to permit active competition in the job market for replacements and additions. College graduates with technical training in such fields as engineering and accounting now commonly receive a starting salary almost double the usual offer of several years ago when graduating classes were larger.

A dollar or more

On March 1 the recent amendment to the Fair Labor Standards Act requires that all workers in covered industries be paid at least one dollar per hour. Labor experts estimate that the nation's wage bill will rise about 560 million dollars yearly as a direct result of the change. In addition, wages of workers above the minimum in affected industries and those in lines not covered by the law will be adjusted to "keep them in line" with competitive rates.

In the South the new law is important in several manufacturing lines, particularly in lumbering, textiles and food processing. Many of these firms indicate that prices will have to rise so that the higher wage cost can be passed along. About one-fourth of all southern workers in manufacturing were paid less than one dollar per hour in 1955.

Relatively few workers in the Midwest will be affected by the change. Wage and Hour Division studies indicate that only the leather and dress shirt businesses in this area employ significant numbers of persons at rates below the new minimum. But there are many banks outside of the large urban centers which employ one or more persons at less than this rate, usually on a monthly basis. One dollar per hour works out to about $173.50 a month for full-time workers. A sprinkling of other persons in the Midwest, usually watchmen or janitors or women working in factories in smaller centers, also will get a wage increase.

About half of the nation's 50 million wage and salary workers are subject to the Fair Labor Standards Act. These include virtually all manufacturing workers and miners, all employees of banks and other financial institutions and the bulk of the nation's transportation and communications workers. Retail and service establishments are specifically excluded.

Learners and handicapped workers can be exempted from the law if a certificate is granted to an employer after application to the Wage

and Hour Division regional office. This provision does not apply to banks, however.

Aside from special cases, therefore, the principal effect of the higher minimum wage will be indirect. It will tend to make the low wage areas of the nation a better market for outside goods, increase the prices of goods made in those areas and reduce the incentive of northern firms to locate new plants in the South. In the unlikely case of a sharp downturn in business, however, the new higher minimum wage could prove to be of considerably greater importance in serving as a floor under rates paid at the low end of the income scale.

Another gain in 1956?

Wage and salary income should be higher in the current year than in 1955. Boosts in salaries and hourly wage rates granted last year will be in effect for all of 1956, and important additional increases are almost certain in a number of basic industries. Total wage and salary payments, of course, will depend also upon the levels of employment and the length of work weeks through the year.

Continued strength of production and sales expected during 1956 should maintain employment near recent advanced levels, but the substantial additions to employment made during 1955 as unemployment was reduced sharply and additional persons were attracted to the work force probably will not be equaled. Moreover, further lengthening of the average work week is unlikely. Under these circumstances, wage and salary gains in 1956 will depend largely upon the rise in the basic pay scale.

Prices at retail counters

Prices at retail as 1956 began were still holding to the plateau they had reached in the wake of the two big splurges in buying touched off by Korea. The official consumer price index in December stood at 114.7 per cent of the 1947-49 average, only half a percentage point above its April-May 1955 level, which was the lowest point since early 1953.

Ups and downs in the index during the past four years have been confined within a 3 per cent range. Neither the mild setback in 1953-54 nor the booming expansion since then, so far at least, has had any significant impact.

Ingredients of stability

Food prices, which exert 29 per cent of the total "influence" on the index, have been tapering downward, allowing for seasonal variation, since 1952. The weakness in food, however, has been confined for the most part to meats. Retail prices of other foods have not reflected fully the post-Korea sag in farm prices, mainly because costs of processing, packaging and distribution have advanced and the amount of these services demanded by consumers has grown.

Meanwhile, most classes of services have been becoming more expensive. Rentals have extended the rise they scored during the period of decontrol, though for the past two years the pace of their climb has been slow. Rents, combined with the prices of other services and goods connected with home ownership and household operation, comprise the most important single category in the consumer price index with one-third of the total weight. In the past two years this housing cost component has climbed about as fast as the food index has fallen. Since the weights for these two big categories are nearly the same, the effects of their contrasting price trends have about canceled out.

Prices of apparel, another 9 per cent of the index, gave ground slowly from the time they passed their post-Korean crest in 1951 until signs of renewed strength cropped out last fall. Similarly, the transportation component of the consumer price index had sagged recurrently after 1953, as sharp declines in used car prices more than offset a year-to-year climb in new car prices and a steady uptrend in gasoline, oil and auto repair services and in city transit fares. On the other hand, medical care costs have continued to mount and prices of items bought for personal care similarly have climbed to higher ground, if erratically and slowly.

The consumer

Most people think of the consumer price index as a measure of changes in "the cost of living" for people generally. Strictly speaking, it is a measure of movements in prices of only those commodities and services commonly bought by families of moderate income living in cities. Still, these families comprise no less than 40 per cent of the total and 64 per cent of the urban population of the nation.

In compiling the official index, the U.S. Bureau of Labor Statistics obtains price quotations for about 300 commodities and services in each of 46 cities. The price quotations are obtained from outlets that typically are patronized by families in the moderate-income groups.

The prices secured for any given city in each survey are compared with those obtained the time before. The relative changes then are found and averaged together after each has been "weighted." The weight is proportional to the importance of the commodity or service the price change applies to in the "market basket" typically bought in that city during some previous period by families in the wage earner—salaried clerical worker group.

Relative importance of items in the consumer price index

December 1955	Per cent
All items	100.0
Food	28.5
Housing	33.3
Apparel	9.3
Transportation	11.1
Medical care	5.2
Personal care	2.2
Reading and recreation	5.2
Other	5.2

SOURCE: Data from U. S. Bureau of Labor Statistics

Contents of the market basket

The composition of the market basket comes from a study of 1950 expenditures made by a sample of moderate-income families in cities all over the country. The results have been up-dated since the study was made to take into account modifications in consumption patterns that occurred between 1950 and 1952.

Because the weights used in the consumer price index reflect the make-up of expenditures for a composite group of families, it is clear that they do not necessarily describe the budget for any one family. Some families spend more than the average on food and, of these, some spend more than most on beef and less on pork. Other families allocate more of their budgets to housing than most do, and so on for other goods and services.

Moreover, in every family budget there are some outlays that somebody would contend are nonessential, that ought to be ignored in finding what it costs that family to live or, more specifically, to subsist. To move from measures of what people do in fact spend and what they spend it for to measurement of the amount they "ought" to spend and what it ought to be spent for, however, is to move onto most uncertain ground. A price index so based would do little to describe the shifting impact of prices on the budgets of flesh-and-blood human beings.

For such reasons as these, incidentally, the index of consumer prices is not referred to officially as the "cost of living index." Probably no one really knows what it costs to live where living amounts only to subsistence. Happily there are few today who are in such straits; a measure of movements in the prices of things

they buy thus would be of little value as a tool of general application.

Buying shifts

For practical reasons the indexers cannot continually alter the contents of the market basket they are pricing. Consumers, however, can and do. There is reason to believe that buying habits have undergone substantial modification even in the short time since 1952, the date of the last budget studies employed to weight the consumer price index.

For one thing, income has advanced: per capita income after taxes is running 8 to 9 per cent higher now than in 1952. Moreover, greater numbers than ever before live out in the suburban areas around the big cities; fewer, relatively speaking, live in the core areas proper. Today's better-heeled families are spending more, proportionately, than even three or four years ago on gardening equipment, automobile expenses and rail commuter tickets, frozen and other processed foods, clothes dryers, vacation travel, sports attire, outdoor barbecue equipment and home and auto air conditioners. And they are spending less, proportionately, on such things as raw foodstuffs, streetcar fares and bus tickets.

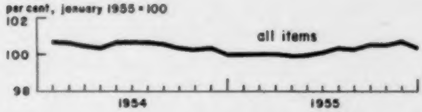
The case of coffee

Some changes in buying habits, of course, are temporary. The big rise in coffee prices between January and August 1954, for example, prompted many consumers to shift to substitutes, like tea and milk, whose prices held the line. For the duration of the coffee-price inflation, which petered out later in the year, the part of the food index based on beverage prices probably overstated somewhat the course of prices for the beverage "market basket" people were actually buying at the time. The reason for this is that the index assumed that people still bought coffee, tea and milk in the same proportions as in 1952.

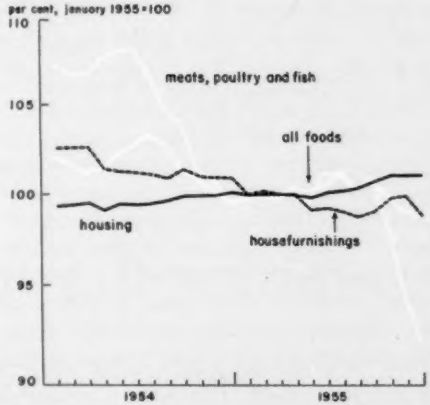
Price activity and index movements

That there has been retail price activity in the past several months is clear from the rec-

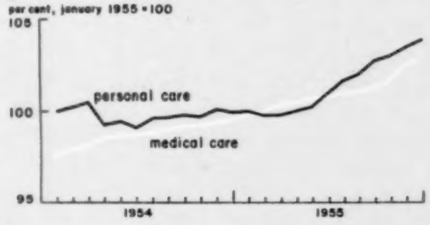
Consumer prices: two years of general stability



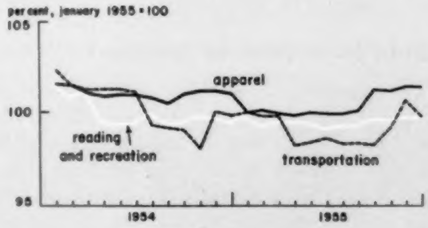
food and housing movements cancel: meat prices push foods down, furnishings buck housing price trend



major service items show sizable gains



other components generally stable



ord. The year's end, particularly, began to see some signs that strength in primary market prices had begun to spill over into prices at retail. Construction costs were continuing to climb, reflecting to some extent recent advances in steel, cement, wood products and nonferrous metals. Television sets and new automobiles were other goods on which bigger tags appeared. Lower prices were reported, meanwhile, for such other consumer hard goods as refrigerators, vacuum cleaners, toasters and washing machines—largely a reflection of some further abandonment of "fair trade" pricing practices. Spring catalogs of the big mail order houses show price increases averaging about 2 per cent over 1955.

How "important" the recent advances have been is another question. So far as the consumer price index is concerned, their impact has to date been negligible. Some of the goods whose prices have risen are not very influential in the index, since spending for them was of limited significance in the 1952 budgets of moderate-income city families. In addition, some higher price tags have been thus far counteracted by falling prices for other items, chiefly foodstuffs and particularly meats. Current expectations, however, are that the drop in food prices has substantially run its course. Consequently, any extended price increases on other important products in the market basket would probably carry the index upward.

Credit for the farm

Farm debt has increased steadily since the end of World War II. Currently, farm borrowings amount to about 17 billion dollars, excluding Commodity Credit Corporation paper, more than double the low figure of 7.7 billion at the end of the War in 1945 and well above the prewar figure of 9.8 billion in 1941. The rise in debt reflects many factors, but in large part it has been due to the higher level of prices and vigorous moves on the part of farmers to mechanize and enlarge farms and to adopt practices which increase output per man-hour, per acre and per animal. For the most part, these moves have required increased amounts of capital and a portion of this has been provided by borrowing.

Debt — servant or burden

The expansion of debt that accompanied the increased rate of commercialization of agriculture since World War II has aroused expressions of concern from time to time. And recently they have become more numerous as debt has continued to mount in the face of a downtrend in farm income.

Even with the substantial increase in recent years, the total farm debt is equal to only 11 per cent of the value of farm assets. In prewar 1940 the corresponding figure was 18 per cent. Judged from another viewpoint, the total outstanding farm debt is now on the order of 50 per cent above the annual net income of farm operators, while before World War II debt was more than double the annual net farm income.

Such broad measures provide at best only very rough criteria for judging the size of an industry's debt. Debts, after all, are obligations of individuals and firms and not of industries. Furthermore, the existence of a debt usually indicates that the borrower incurred the debt to obtain the use of capital which otherwise would not be available to him. The key factors in any evaluation of debt, therefore, are (1) is the debt sound in the sense that it can be repaid as planned and (2) can the borrower use the additional capital profitably. If both of these

criteria are satisfied, it can be concluded that individual debts are serving useful purposes for both borrowers and lenders and at the same time are improving the economic efficiency of the industry of which they are a part. On the other hand, when debts are not paid as planned or debtors' earning power is not increased as a result of their control of the additional capital, debt may prove burdensome.

Currently, some lenders report that farmers who were able to obtain all the credit they desired last year are now limited in the amounts of funds they can obtain because profit margins have narrowed and values have declined on the chattels offered for security. Also, some farmers have been unable to pay old loans as planned due to the effects of drouth and lower prices. This situation is especially noticeable, of course, among those farmers who have small equities in their business, most often tenants and beginning farmers.

Current trends in farm debt

During the first half of 1955, the amount of farm mortgages written spurted to 1.3 billion dollars, a gain of 29 per cent over the year-earlier period. And it appears that a high rate was maintained during the latter half of the year. Farm mortgage debt outstanding, of course, did not rise a corresponding amount, due to principal repayments and the fact that a part of the mortgages written in any period represent refinancings. Nevertheless, outstandings increased by 800 million dollars or about 10 per cent for a substantially larger gain than in other recent years.

Underlying the growth in real estate debt have been rising land values, a larger average size of loan and a larger number of sales of farm land financed with credit. In addition, the substantial increase in real estate debt in 1955 apparently reflects some increase in the amount of refinancings.

Farmers who find their "short-term" debts to be burdensome often refinance them into longer-term obligations secured by real estate mortgages. This reduces their annual principal payments and often reduces the interest rate as well. Usually, shifts to mortgage debt occur after relatively high levels of short-term debt have been incurred and income falls below expected levels.

Non-real estate loans to farmers (excluding CCC loans) increased by 10 per cent or more during 1955. The increase was due to efforts of many farmers to expand the size of their business in order to utilize efficiently their available labor and machinery as well as to borrowing to finance a continued high level of operating expenses and a slower rate of repayments.

Credit needs

Farm debt is likely to show further growth. Farmers can be expected to use larger amounts of borrowed capital as they continue to adjust their businesses so as to gain the benefits of improved machinery and expand their use of purchased materials and services needed for efficient production of crops and livestock. Purchases of machinery, feed, petroleum products, electric power and fertilizer, lime and other agricultural chemicals are likely to increase further. Low farm income may reduce outlays for some of these items in individual years, but their use is essential to efficient production. Hence, over a period of years, operating capital needs and "short-term" farm debt probably will expand further.

Debt secured by mortgages on farm real estate has shown a persistent growth and probably will continue to grow as the portion of farm transfers financed by credit rises further and down payments account for a smaller share of sales values. Mortgage credit is also likely to get a lift as a source of funds to finance machinery and farm enlargement and improvement programs. Credit for these purposes frequently is repaid over a period of several years and may increasingly be written on notes secured by farm real estate mortgages.

Agricultural lenders, therefore, are likely to find opportunities to supply additional funds to their farm customers. Whether the increase will be largely in loans secured by mortgages on farm real estate or in non-real estate loans

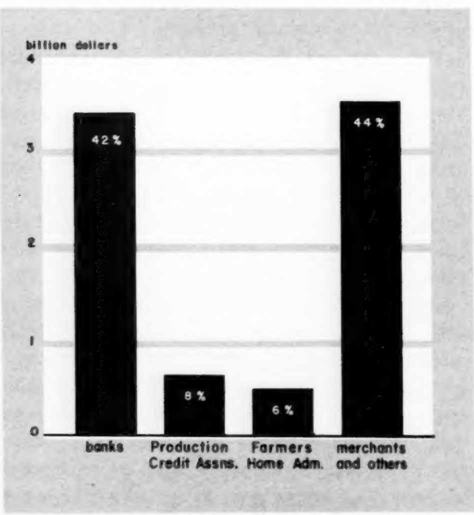
is less certain. For farm owners who have considerable equity in land, the credit expansion could come in either or both forms. For tenant operators, it must necessarily be largely in non-real estate credit.

Sources of credit

Just as credit performs a wide variety of services in agriculture, so also do the farm loans come from a variety of sources. Insurance companies, Federal Land Banks, the Farmers' Home Administration, Production Credit Associations and large manufacturers and distributors of farm supplies together provide about half of the credit used by farmers. These lenders all have direct access to the national money market. The remaining half of the farm credit is largely from local sources —country banks, retailers and individuals.

Lenders tend to specialize in different kinds of credit, each extending a type which is consistent with that institution's financial characteristics. And over the years, as the methods of farming and the credit needs of agriculture have changed, new kinds of loans and sometimes additional credit institutions have been established as is evident from the vast and intricate structure of farm credit and financing practices in the United States today.

Banks and merchants provide most of the non-real estate farm credit (amounts outstanding January 1, 1956)



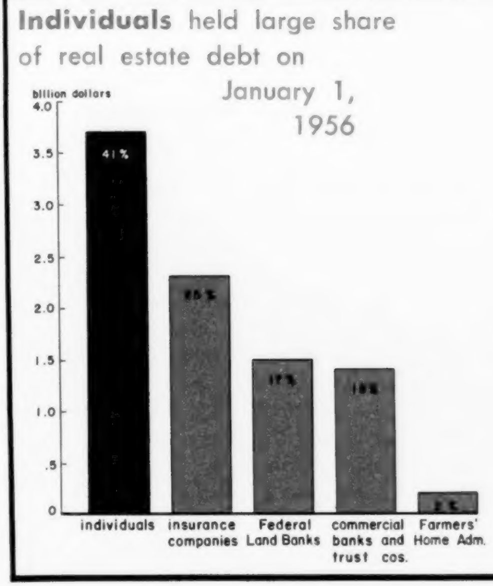
Non-real estate credit. About one-third of the non-real estate loans to farmers are unsecured in the sense that no specific assets are pledged to insure payment. The remainder are secured by mortgages on chattels or the endorsement of someone having a good credit rating. These loans usually have maturities of about six months and frequently are made with an understanding that they can be renewed at maturity if the circumstances warrant such action. Occasionally they are written for any period up to two or three years.

Interest rates vary considerably; commercial lenders are charging from 4 to 7 per cent in the Midwest at the present time, the smaller and higher risk loans carrying the higher rates.

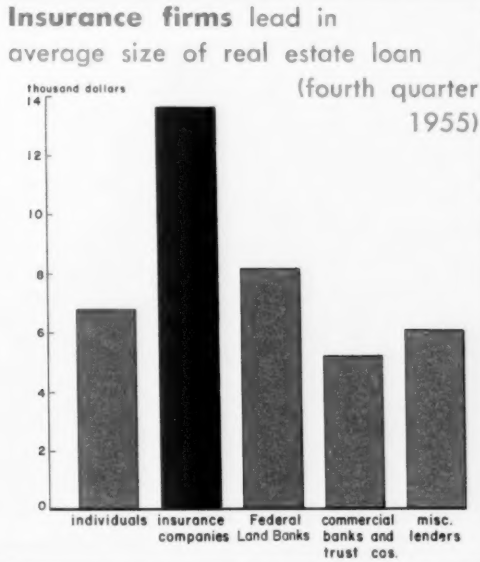
Principal sources of non-real estate credit in the U.S. are banks, Production Credit Associations, the Farmers' Home Administration and merchants. The relative importance of these sources of so-called "short-term" credit is shown in the accompanying chart.

Real estate credit. The transfer of asset ownership is essential in unincorporated business, if only because everybody dies sometime. Because farms typically are not owned by corporations and since land generally is transferred in sizable parcels of considerable value, over one-half of the transfers currently involve the use of credit. More credit is required for this purpose if land values per acre rise and the average size of farm increases, as has been happening for the past decade.

The relatively low interest rate on real estate loans (4 to 5½ per cent currently in the Midwest) is the result of their large size, long term and the characteristics of the security back of the loan. With a larger loan and long maturity, processing and servicing costs per dollar of outstanding debt are smaller. And since farm real estate is both productive and durable, it provides excellent security for loans. The principal hazard is a decline in market value,



Individuals held large share of real estate debt on January 1, 1956



Insurance firms lead in average size of real estate loan (fourth quarter 1955)

and lenders guard against that eventuality by loaning only a fraction—say 60 per cent—of the appraised value of the property.

Together, insurance companies, Federal Land Banks and commercial banks and trust companies hold about 60 per cent of the total farm mortgage debt. The remaining two-fifths are held by individuals and other miscellaneous lenders.

Individuals often extend real estate credit to finance a transaction within the family. This type of credit also arises from the sale of land to buyers whose available cash or net worth is not sufficient to justify their being considered good credit risks by commercial lenders or, when a farmer retires, he may wish to exchange his equity in a farm for the more secure return obtained from holding a debt.

The most specialized commercial sources of farm real estate credit are the insurance companies and the Land Banks. Long maturity loans are "tailor made" investments for life insurance companies as they have a regular supply of loanable funds as well as a regular and predictable "pay out" on their policies.

Federal Land Banks were instituted by the Government in 1916 to make additional funds available for farm real estate loans, to provide loans at lower rates of interest and to introduce more orderly, long-term financing practices. Land Banks obtain their funds by selling securities in the national market.

Real estate loans by banks average smaller in size and have shorter maturities than those of other lenders. Because of these factors the interest rate charged by banks for real estate loans usually averages higher than that charged by the Federal Land Banks and insurance companies.

As was the case with insurance companies, the type of farm real estate loan in which the banks specialize is determined by the financial characteristics and investment needs of the lending institution. Bank deposits—even time deposits—are a less regular source of funds than the inflow of life insurance premiums. Also, the rate of possible "pay out" is more uncertain. Consequently, commercial banks

Uses of farm real estate credit granted by . . .

	Insurance companies	Federal Land Banks	Commercial banks
		(per cent)	
Purchase of real estate . .	30	20	27
Repairs and improvements to buildings and land . .	8	13	9
Refinancing of farm real estate mortgages	35	33	14
Refinancing of non-real estate debt	20	16	
Financing of livestock, machinery and operating expenses . .	7	18	50
	100	100	100

tend to specialize in shorter maturity loans. Banks with a substant al volume of time deposits are in a better position to make real estate loans than are banks which concentrate more heavily in demand deposits.

An important share of farm real estate credit extended by banks is used for "intermediate" purposes like the purchase of machinery and livestock as well as general production and operating expenses like feed, fertilizer, seed and petroleum products. This helps explain why the average maturity of farm real estate loans made by banks is so short—less than five years.

Commercial banks are unusually well suited to provide loans for these purposes on an intermediate-term (two-to-five year) basis as the size of the loan is ordinarily not as big, nor the maturity as long, as for loans made to finance the purchase of a farm. A local credit institution is also a desirable source for this type of credit since such loans usually require a rather intimate knowledge of the character and needs of the farm business.

Currently, agricultural lenders are looking more closely at the total credit picture for individual farms. Any move in the direction of an integrated credit program for whole farm businesses will probably elevate real estate credit to a more important position. As some lenders make the shift, further evolution of credit instruments, institutions and loan procedures will no doubt occur.

Credit availability

With the wide variety of lenders now serving agriculture, it is reasonably certain that the credit needs of farming will be adequately served in the foreseeable future. However, in any period, the pool of loanable funds is not inexhaustible. Farmers must compete with other borrowers for the available supply whether the funds originate from local sources or a national market. This is not the case, of course, for direct Government loans such as those made by the Farmers' Home Administration.

Consumers, businesses and governmental bodies have been aggressive borrowers in the past year. Furthermore, deposits in agricultural banks in the District have been running about 3 per cent below year-earlier levels and in the livestock areas of Iowa and Illinois have lagged year-earlier levels by 6-9 per cent. As a result of these trends, some banks have borrowed from their Reserve Bank, sold Government securities and turned in CCC paper to obtain funds to accommodate the demand for loans. By and large, however, rural banks have had a substantial amount of elbow room to accommodate their customers, and it seems quite certain that credit for alert managers of efficient farm units will continue to be a sound investment for lender and borrower alike.

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